No. 22093

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

v.

LEE HOFFMAN and JUDY HOFFMAN,
husband and wife,

Appellees.

FILED

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BRIEF OF APPELLEES

Appeal from the United States District Court for the District of Oregon

Honorable Gus J. Solomon, District Judge

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OPINION, BELOW, JURISDICTION, QUESTIONS PRESENTED, AND STATUTES AND REGULATIONS INVOLVED.

Appellees accept appellant's statement of opinion below, jurisdiction, questions presented, and statutes and regulations involved, as expanded by a more extensive statement of the case, *infra*. Pertinent statutory and regulatory material is presented in Appendix A, *infra*.

STATEMENT OF THE CASE

Simplification and solution of the issues presented demand a more complete statement of the case.

Three sections of the Internal Revenue labyrinth are pertinent: 26 U.S.C. §§ 165, 166 and 172 (hereinafter sometimes referred to for sake of brevity variously as "§ 165," "§ 166," and "§ 172").

Section 165 considers "losses." Any loss uncompensated by insurance is deductible, 26 U.S.C. § 165(a), to the extent of the taxpayer's adjusted basis, 26 U.S.C. § 165(b). However, § 165(c) limits loss deductions for individuals to (1) losses incurred in a trade or business; (2) losses incurred in transactions entered for profit, unconnected with a trade or business; and (3) casualty losses exceeding $100. Capital losses and losse from worthless securities are limited to the amount of the applicable capital gain and $1,000, 26 U.S.C. § 165(f), (g).

Section 166 is concerned with "bad debts." Bad debts are generally deductible; however, for an individual taxpayer, no bad debt deduction is allowed for nonbusiness debts in excess of capital gains plus $1,000. 26 U.S.C. § 166(a), (b), (d) (1). A "nonbusiness bad debt" is defined as a debt which is not create or acquired in connection with, or incurred in, the taxpayer's trade or business.

Section 172 deals with net operating loss deductions. It is an ameliorative section allowing carry-back and carry-

over of excess of deductions over income, across lines of accounting periods. Section 172 (d)(4) provides that an individual taxpayer's deductions which are not attributable to his trade or business will be allowed only to the extent of his gross income not derived from his trade or business.

The instant transactions must be considered in connection with these sections. Taxpayers timely filed an action for refund of $9,345.61, representing overpayments of federal income taxes for the tax years 1958 through 1961, inclusive. (R. 1-22, 78-79.) Taxpayers' action was premised upon refund claims (R. 5-22, see Ex. "A", "B", "C", "D" and "E" to complaint) which were rejected [except for a portion of the 1961 refund claim in the amount of $243.99 (R. 3)], by the Internal Revenue Service. In denying the refund claims, the Government disallowed taxpayers' claimed loss deduction except for the extent of $1,000, plus applicable capital gains, and contended that the losses were capital losses (R. 3; admitted, R. 24).

Taxpayer Lee Hoffman operated a highly successful contracting business prior to 1958 as a sole proprietor (R. 29, 111-121). At that time, he organized Lee Hoffman, Inc., (the "corporation" per Br. 5); Mr. Hoffman was president, director and sole stockholder; he received a salary for his efforts as president (Br. 5; R. 5-22, 79).

On June 15, 1958, the taxpayers, the corporation and the General Insurance Company of America ("bonding company" in the Government's brief and hereinafter referred to as "General"),

entered into an agreement (R. 34-37). The contract was in the standard form used by surety companies from time immemorial. There was no evidence of any negotiated provisions on behalf of the taxpayers or the corporation. In this sense, it was a "contract of adhesion."

The agreement with General provided, inter alia, that General would furnish performance and payment bonds; in return, the taxpayers individually agreed to indemnify General for any losses which might arise out of, or on account of, the execution of such bond. (See e.g., R. 34-37, confirm R. 79-80).

Bonding requirements for construction contracts are virtually universal, due in no small part to the infusion of federal, state and local governmental money into almost all construction projects, both "public" and "private".

Realistically, a contractor cannot secure the necessary payment and performance bonds without execution of an indemnity agreement resembling the documents here entered. (See R. 30.)

On September 9, 1959, the corporation entered into a contract with Oak Lodge Sanitary District No. 1, for the construction of a sanitary sewer system in the gross amount of $2,122,881.75, and General provided the payment and performance bonds required by Oregon law, pursuant to the parties' agreement. (R. 30-31, confirm, R. 80.) On July 20, 1960, the corporation entered into a second contract with Oak Lodge Sanitary District No. 2, for the construction of a sanitary sewer system in the gross sum of $1,294,243; likewise, General provided payment and

performance bonds. (R. 31; confirm R. 80.)

The corporation suffered financial reverses. On April 11, 1961, an agreement was entered into between the corporation, General, The First National Bank of Oregon (hereinafter referred to as "Bank") as a conduit, and taxpayers as indemnitors. (R. 31, 38-53.)

On April 21, 1961, taxpayers sold real property subject to the foregoing agreement, and the net proceeds ($20,400.83) were transferred to General in conformity with the indemnity agreement. (R. 31, 80.)

Thereafter, on November 20, 1961, the agreement of April 11 was terminated and General paid the bank the sum of $500,199.81, pursuant to Paragraph 7 (R. 40); this amount represented the monies advanced to fund the completion and performance of the two contracts. (In large part, the funds were utilized to discharge claims such as mechanics' liens). This sum reflected as credits all payments previously received from the individual indemnitors and the corporation. (R. 31-32.)

A new agreement was entered November 22, 1961, which eliminated the Bank as conduit for the funds (R. 32, 54-57). This contract provided that General was to advance the corporatio the amounts necessary to complete the contracts, and the corporation and the indemnitors agreed to repay General on demand for all advances, including monies advanced under the prior agreement and the agreement of indemnity dated June 15, 1958. The agreement specifically provided that it was not to limit or

modify any rights existing under the prior agreement. (R. 57.)

On November 30, 1962, a release and settlement agreement was entered into between the bank, General and taxpayer Judith Hoffman for herself individually and as guardian of the estate of taxpayer Lee H. Hoffman, an incompetent (R. 58-68). Prior to November 30, 1962, taxpayers liquidated certain common stocks and paid the proceeds to General. The basis of this property for federal income tax purposes was $2,740. On November 30, 1962, taxpayers transferred cash, stock and real property to General for a full and complete release of all liabilities to General, which the Court found at that time exceeded $900,000 (R. 58, 80-81.) The basis of this property in the hands of taxpayers was $56,223.40 (R. 32-33). The property so transferred had a value in excess of the basis, but less than the amount of the debt to General. Provision 3 of the release and settlement agreement provided:

> "INDEMNITORS warrant and affirm that they have made a full disclosure of all of their assets, and that in addition to the assets described in Schedules A and B the only property owned by INDEMNITORS is that described in Schedule C hereto attached, which Schedule is made a part of this paragraph as fully as though set forth completely herein. In the event that it is discovered at any time that any property has been omitted from Schedules A, B and C, INDEMNITORS agree to convey the same to BANK, and GENERAL immediately." (R. 59). /Emphasis in original./

Indemnitors conveyed, inter alia, pursuant to Schedule A (R. 63-64), a portion of taxpayer Lee Hoffman's birthright:

> "Two-thirds of the one-fourth contingent remainder interest of Lee H. Hoffman in and to the trust

estate created by the will of the late Lee Hawley Hoffman, father of Lee H. Hoffman by which the remainder of the estate of Lee Hawley Hoffman, deceased, was conveyed in trust to Eric Hoffman and Walter Burns Hoffman as trustees, which remainder interest is subject to a life estate in said trust property for Carolyn Couch Hoffman, the mother of Lee H. Hoffman, and said contingent remainder interest is to vest in Lee H. Hoffman in the event that he survives his mother, all as in the will of Lee Hawley Hoffman set forth and probated in the Circuit Court of the State of Oregon for the County of Multnomah under Cause No. 84008."

Timely refund claims were filed by taxpayers with the Internal Revenue Service for tax years 1958-1961, inclusive. Taxpayers asserted that the amounts paid to General, pursuant to the foregoing agreements, were deductible as "ordinary losses" which could be "carried back"; they deducted their basis for the property included in the payments and listed them as "loss-payment to General Insurance Company under Indemnity Agreement" (R. 7, 9, 15). The Internal Revenue Service rejected these refund claims, contending that the losses were capital losses (R. 3, 24).

Taxpayers' timely complaint for refund (R. 1, et seq), was answered by the Government (R. 23-24). Thereafter, taxpayers moved for summary judgment pursuant to Rule 56, Fed. R. Civ. Pr., 28 U.S.C. (R. 25), supported by appropriate memoranda (R. 26-28), affidavits, and incorporated documents (R. 29-67). <u>All facts were admitted by the Government at this stage</u> (e.g., Tr. 37; R. 24, 100, 102).

The Government moved to deny taxpayers' motion for summary judgment and filed a cross-motion for summary judgment

(R. 69). The Court entered judgment for the taxpayers (R. 84) on March 21, 1967, premised upon the opinion and order of the Honorable Gus J. Solomon, Chief Judge of the United States District Court for the District of Oregon (R. 78-83). The Court considered the issues as if a trial were had on the merits on stipulated facts, not on the respective motions for summary judgment (Tr. 37; R. 83). On May 16, 1967, the Government filed its notice of appeal (R. 85). On June 20, 1967, the Government, unopposed, was permitted to extend the time permitted to docket the record on appeal for the full 90 days (R. 86).

Long after entry of judgment and filing of notice of appeal, the Government sought to amend judgment (Tr. 87-88); the motion to amend was filed and served July 10, 1967 (R. 147). The motion to amend was denied (Tr. 92).

SUMMARY OF ARGUMENT

The losses incurred by the taxpayers as indemnitors of General are deductible as "ordinary losses" pursuant to 26 U.S.C. § 165(c).

Taxpayers' losses were not "nonbusiness bad debts" under 26 U.S.C. § 166(d). Plaintiffs reserved no right of subrogation in their indemnity contract, and the parties' intent militates against retention of such a right, particularly where all assets, including all of the corporation's stock, was transferred to General.

Assuming, *arguendo*, that some implied right to subro-

gation could be available to an indemnitor, that right did not exist under the admitted facts. A party is not entitled to split his cause of action, and taxpayers failed to discharge the entire debt, which exceeded $900,000. Since taxpayers did not liquidate the complete debt, they possessed no right of subrogation.

Moreover, taxpayers and General entered into a release and compromise as to all claims against both taxpayers and their corporation in November, 1962. When a claim is compromised, the promisor retains no subrogation rights.

Losses sustained by an indemnitor pursuant to an indemnit agreement are ordinary losses; they cannot be tortured into "non-business bad debts" where, as here, the indemnitor has no right of subrogation. Any lack of uniformity posited by the Government because of this rule, derives from artifical administrative and judicial distinctions; there is no reason to thwart a taxpayer's right to ordinary-loss treatment by administrative fiat here where the taxpayer clearly comes within the ambit of the statute.

Taxpayers' losses are not capital losses under 26 U.S.C. § 165(f), (g). Any contention that payments by taxpayers to General pursuant to the compulsion of the indemnity agreement constituted contributions to capital is patently ludicrous.

The district court properly denied the Government's motion to reduce judgment. The motion was untimely filed and served; indeed, the motion was filed 111 days after the judgment

was entered, and 55 days after the Government filed notice of appeal (R. 84, 85, 87-88, 147). While the motion and supporting documents omitted the date (R. 87-88), the record clearly sustains taxpayers' contention of untimeliness (R. 92, 147). Footnote 22 (Br. 48-89) is a specious excuse. If the Government is held to some modicum of fairness, it is not free to reopen that which has been settled and admitted.[1]

Moreover, taxpayers were relieved of any obligation to submit evidence on the "trade or business" issue by reason of the Government's judicial admissions.

Finally, there was evidence (from the admitted facts) that the taxpayer was engaged in the trade or business of rendering managerial and other services to the corporation, and that the furnishing of the indemnity agreement was done in connection with such a trade or business. The Government is barred and estopped from raising this issue in light of its conduct, judicial admissions, and untimely action. The judgment of the district court should be affirmed.

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[1] It should be noted that the government cites the transcript of the hearing on the motion without designating the transcript as part of the record on appeal. The Government's motion to amend was not "summarily" denied, but was denied fifteen days after it was filed and only after both parties had submitted written briefs in support of their positions. (R. 89, 92, 146).

ARGUMENT

I.

Taxpayers-Plaintiffs' Losses Were "Ordinary Losses," Fully Deductible Under 26 U.S.C. § 165(c)

Taxpayers made payments to General under their direct obligation contained in the indemnity agreement. As the result, taxpayers suffered deductible "ordinary losses." 26 U.S.C. §165.

Any tiresome commentary concerning bad debts, business or nonbusiness in character, asserts interesting trivia, wholly irrelevant to this case. It is sufficiently difficult to comprehend the tortured theorizing of Putnam and its progeny /Putnam v. Commissioner of Internal Revenue, 352 U.S. 82 (1956)/, wherein an ordinary loss transaction (at least a transaction so conceived by the common taxpayer) is painfully ensconced in the Procrustean bed of "bad debts." If this Court chooses to adopt the Government's position, the law will be encrusted with an additional anomaly. If deductions for ordinary losses should be limited in scope (the apparent major premise of the Government's arguments), should not the power of change reside in Congress instead of interested administrative advocates?

Appellant renders the issue unnecessarily complex. Taxpayers suffered a loss by any rational standard. The bad-debt provisions of the Code are irrelevant. The sole issue, then, is whether the loss was "an ordinary loss" or "a capital loss." The Government's argument on this point[2] is easily reduced to

2 See Government's argument II, Br. 43-47, answered more specifically in II, infra.

absurdity. Therefore, the district court properly applied 26 U.S.C. § 165 to the case at bar. The decision was clearly correct and should be upheld. The Court's findings are presumptively valid and will be sustained unless found to be clearly erroneous. See, e.g., Rule 52, Fed. R. Civ. Pr., 28 U.S.C.; Commissioner of Internal Revenue v. Duberstein, 363 U.S. 278 (1960); McAllister v. United States, 348 U.S. 19 (1954); United States v. Gypsum Company, 333 U.S. 364, [rehearing denied 333 U.S. 869 (1948)].

A. Introduction

The governmental assertion of unnecessary issues requires a more lengthy reply by taxpayers, in order to avoid apparent acceptance of invalid arguments by failure to comment. Insofar as desirable, taxpayers will follow the appellant's division of argument.

Appellant's "Introduction" (Br. 16-19) contains several statements materially erroneous:

(1) The Government asserts that the taxpayers paid General pursuant to its direct indemnity obligation "and were unable to obtain repayment from the corporation" (Br. 17). This error, repeated in various forms throughout appellant's brief, betrays the Government's confused analysis of the total transaction. Taxpayers were either entitled to subrogation against the corporation, or not, as a matter of law; no factual question is presented. If there exists no right of subrogation, a party cannot voluntarily relinquish such a nonexistent right

(apparently this is the Government's position in one of its several guises). Here, the taxpayers made no attempt to claim against the corporation --they possessed no right or basis to do so.

It is patently ridiculous to claim that taxpayers relinquished a right not owned or possessed. Such a claim would necessarily assume the control and ownership of the subrogee. Here, taxpayers transferred their entire fortune, <u>including all shares of stock in the corporation</u>, to General (R. 58-68). Taxpayers and General, dealing at arms' length, entered into a business transaction. One can hardly suppose that General intended to have that bargain undercut by taxpayers' assertion of a right of subrogation against some of its assets. Taxpayers did nothing voluntarily; certainly they paid no debts or infused no capital into the failing corporation at the time the agreements were executed. No rational person would make any additional commitment of capital to this unhealthy enterprise subsequent to its insolvency.

Moreover, the obvious intent of the release (R. 58-67) was to permit General to take all of the meat from the corporate bones; how does appellant, so fixed upon "realities," believe that this bargain reserved an unimpaired right to subrogation?

(2) The Government states the question to be whether the loss is a nonbusiness bad debt loss or a loss fully deductible under 26 U.S.C. § 165(c)(2) "as a loss incurred in a transaction entered into for profit though not connected with a trade or business, <u>as taxpayers contended</u>" (Br. 17) (Emphasis added).

The record does not reflect a basis for this statement although the transcript, not a part of the record, might do so. 26 U.S.C. § 165(c) permits ordinary loss treatment to (1) losses incurred in a trade or business; (2) losses incurred in a transaction entered into for profit, unconnected with a trade or business; (3) casualty losses exceeding $100, unconnected with a trade or business. Taxpayers did not specify in their refund claims or complaint that the loss fell within a specific subsection of § 165.

The refund claims of taxpayers asserted the right to carry back losses from 1961 and 1962 for "Payment(s) to General Insurance Company under Indemnity Agreement". The government's position through judgment was consistently that the loss was a capital loss because it was a bad debt or a contribution to capital. Each party filed a motion for summary judgment asserting that no issue of fact remained for the court. The parties agreed that these motions could be considered by the court as a pre-trial order setting forth the respective contentions.[3] At this stage it was truly irrelevant whether tax-

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[3] "Mr. Moore: Your Honor, there is one thing we do agree on, if the Court should, after going over the documents in the case, decide that it wishes additional evidence or affidavits or any additional testimony on any factual issue, we would like to treat the motion for summary judgment as a pretrial order and limit the issues as much as possible. I don't think that's the case.

Mr. Smith: This is agreeable to us, your Honor." (Tr. 36-37)

payers relied on § 165(c)(1) or § 165(c)(2) since the Government had never asserted § 172(d)(4) as a partial defense. It was only 111 days after the court, in reliance upon the contentions of the parties, entered its decision and judgment that the Government suggested that a portion of taxpayers' loss could not be carried back.

Conceptually, taxpayers suffered the loss in their trade or business. The admitted facts indicate that taxpayer Lee Hoffman was engaged in the trade or business of rendering managerial and other services to the corporation, and that the furnishing of the indemnity agreement was performed in connection with such a trade or business. Taxpayer was the salaried president of the corporation, and anticipated payment for services if the enterprise was successful. The corporation was unable to bid on public contracts without bonding capacity, and could not obtain satisfactory bonding power without the indemnity agreement of the taxpayer.[4]

(3) Appellant makes the unreasonable assertion[5] that taxpayers advanced funds for necessary operating capital via the agreement with General and in some manner secured a "tax break" unavailable to ordinary mortals (see, e.g., Br. 17-19). No one

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[4] See Argument III, infra, for further comment. Admittedly, after the stipulations by Government foreclosed any inquiry as to carryback, the taxpayers' counsel asserted the claim and argument under 26 U.S.C. § 165(c)(2) (e.g., Tr. 19, 20, 30). However, taxpayers have no compunction about advancing additional theories since the Government feels free to reopen foreclosed contentions (Br. 48, et seq; see Argument III, infra).

[5] Repeated in various guises throughout the appellant's brief.

advanced funds to the corporation. General invested no capital in the corporation; its payments liquidated only existing claims arising out of the Oak Lodge contracts, such as mechanics' and materialmen's liens--for this was its obligation under its bonds furnished pursuant to the Oregon statute. To make the argument serves only to waste time and temper. The indemnity agreement (R. 34-37) was executed June 15, 1958. The corporation was formed shortly prior thereto. The corporation needed no funds in 1958; it was adequately capitalized. No one foresaw the future financial predicament when the indemnity agreement was executed. Can it be earnestly contended that taxpayers intended to use this method to secure capital contributions? Would the taxpayers have entered this agreement in 1958 if they had known that in five years it would cost them their entire fortune? The mind boggles at such a prospect.

The Government appears to believe that all agreements were executed contemporaneously; it was almost three years after the execution of the indemnity agreement that the first loan agreement was executed under the compulsion of the indemnity contract.[6] One year later, November 30, 1962, the release between taxpayers and General was executed (R. 58-67). As indicated infra, it is absurd to contend that any rational being would make a "capital investment" in the corporation in 1961. The taxpayers lost their personal fortune only because they were

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[6] The agreement of April 11, 1961, appears at R. 38-53; the agreement of November 22, 1961, appears at R. 54-57.

required to execute the indemnity agreement. No one would have invested risk capital in the corporation in 1961 or 1962 at a time when the corporation was unable to pay more than $500,000 in obligations.

(4) Finally, the Government says that the taxpayers' position is unrealisitic and "exalts form over substance" (Br. 19). These are handy tools to replace analysis, but the language seems singularly hollow here. If the leviathan of Internal Revenue is "formalistic," "legalistic," or "unrealistic," it is hardly the fault of the taxpayers. The Commissioner, constantly grasping for alteration of the statutes to the increase of income, must answer for any untoward formalism. Nor are the courts free from criticism when one considers the tenuous reasoning of Putnam v. Commissioner, 352 U.S. 82 (1956), which twisted an ordinary loss into a "bad debt" through application of the legalistic principles of subrogation.

In plain language, taxpayers have suffered an ordinary loss in their trade or business. Congress permits deduction in full of ordinary losses under 26 U.S.C. § 165. Any layman given the hypothetical would immediately recognize the transaction as a trade or business loss, not a bad debt. All should labor diligently to avoid making the law any more unrealistic than it already is. If the law should be changed, Congress is the appropriate body to effect that change.

B. Much Ado About Bad-Debt Losses

Appellant asserts (Br. 20-24) that nonbusiness bad-debt

losses are deductible as capital losses, 26 U.S.C. § 166(d), not as ordinary losses, 26 U.S.C. § 165(c). The statement may be valid but it is irrelevant, since the instant litigation is unconcerned with bad debts, business or nonbusiness in character. See Argument I, supra. Since this case does not fall within the "carved out" (Br. 22) area, appellant's historical analysis is academically interesting but pragmatically unhelpful. The Government concludes that there is "no question that the loss is of a nonbusiness character," and therefore subject to capital-loss treatment (Br. 23-24). This exhortatory statement should be disregarded as wholly unsupported by the record.

C. Taxpayers Suffered Ordinary Losses in a Venture for Profit, and Possessed No Rights of Subrogation Against General. Therefore, Taxpayers are Entitled to an Ordinary Loss Deduction.

The Government relies upon Putnam v. Commissioner, supra, in support of its conclusion that these were "nonbusiness bad-debt" losses. Putnam admittedly is the law. But Putnam was concerned with a guaranty agreement, a secondary obligation, where the taxpayer had a right of subrogation against the primary obligor. While the Government may decry this as undue formalism, it has become legally important, and it is Putnam which is the product of the original formalistic approach.

Taxpayers here suffered an ordinary loss for which the statute allows complete deduction, 26 U.S.C. § 165. If taxpayers paid General pursuant to their obligation as indemnitors and the losses sustained by the plaintiff were incurred as a

result of a profit-seeking activity, then plaintiffs are entitled to ordinary-loss treatment. The district court found the plaintiffs clearly within the ambit of 26 U.S.C. § 165, and that judgment should be affirmed.

The salient inquiry investigates the nature of the plaintiffs' obligation: Were plaintiffs indemnitors of General or guarantors of the corporation? The legal consequences of this inquiry are important. A contract of indemnity is an original undertaking - a primary obligation - as opposed to an agreement to answer for the debt, default or miscarriage of another. In the executed indemnity agreement there exists no "bad debt" comparable to a situation where one party guarantees the obligation of the second. Howell v. Commissioner, 69 F.2d 447 (8th Cir. 1934). See also, in different contexts, Atterbury v. Carpenter, 321 F.2d 921 (9th Cir. 1963) (promissor held to be a surety, not indemnitor); Union Oil Company of California v. Lull, 220 Or. 412, 349 P.2d 243 (1960) (liability of credit card holder to issuer for unauthorized charges); Standard Oil Company of New Jersey v. Commissioner, 7 T.C. 1310 (1946).

Plaintiffs were indemnitors of General. The contract (R. 34-37) established the right of General to proceed directly and primarily against the plaintiffs without first exhausting remedies against the corporation. Plaintiffs retained no rights of subrogation, express or implied, against the corporation. The payments made by plaintiffs by reason of their promise (to hold General harmless from all losses arising by reason of the

bond issued to the corporation) were payments of a direct, primary obligation. As a result, plaintiffs were entitled to an immediate loss-deduction from ordinary income if the payments were qualifed under 26 U.S.C. § 165. Commissioner of Internal Revenue v. Condit, 333 F.2d 585, 586 (10th Cir. 1964); Rietzke v. Commissioner, 40 T.C. 443, 452 (1963); see also Mankoff, Raymond M. "Deduction of Indemnity Losses under §165", 50 A.B.A.J 783 (1964). A loss deduction pursuant to 26 U.S.C. § 165 is permitted if (1) a loss is sustained and (2) the loss was incurred in a transaction entered into for profit.

Taxpayers parted with money and property of a value exceeding their basis ($56,000), but less than the amount of the primary obligation, pursuant to the terms of their agreement with General. This transaction established the losses in the pertinent years.

Taxpayers provided indemnity to General for a valid business purpose. As the result, bonding requirements were met which, it was anticipated, would increase the value of plaintiffs' equity ownership and would pay the plaintiff Lee Hoffman's salary. See Rietzke v. Commissioner, supra; J. J. Shea v. Commissioner, 36 T.C. 577 (1961) [affirmed, per curiam, 327 F.2d 102 (5th Cir. 1954)]; Horner v. Commissioner, 35 T.C. 231 (1960).

The ability of the corporation to conduct business depended upon its bondability. The corporation's ability to furnish bond depended upon the willingness of the taxpayers to

agree to indemnify the compensated surety. If the corporation was unable to conduct its business, it could ill afford to remunerate taxpayer Lee Hoffman for his services rendered as president, and the value of the corporate stock would have been impaired.

Plaintiffs did not select the form of their obligation to General. The indemnity agreement is a form long utilized by compensated sureties. Plaintiffs were required by General to execute the agreement as a condition precedent to the issuance of payment and performance bonds in their business. The reason for General's choice of indemnity agreement (as opposed to a guaranty) is obvious: General desired that the plaintiffs become, in effect, the insurers of General.[7] Any loss incurred by the compensated surety could be collected directly from the plaintiffs-indemnitors without the necessity of proving demand from, or exhaustion of remedies against, the corporation. In order to collect from the indemnitors, General had no duty to even show an obligation from the corporation.

Under these circumstances, satisfaction of plaintiffs' obligation cannot be classified as a bad debt. The legalistic reasoning necessary (<u>via</u> application of subrogation principles) to classify payment by a guarantor as a "bad debt" loss, is simply not applicable to payment made pursuant to a contract

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[7] See "insurance" as one definition of indemnity in the Restatement of Security, cited Br. 26.

of indemnity. Payments under a contract of indemnity, as here, do not take the form of loans, stock purchases, capital contributions, or guarantees of bad debts - as the Government variously attempts to categorize this transaction.

The Government continually resorts to the untenable assumption that plaintiffs somehow "avoided" or "waived" their "worthless right of subrogation." (See e.g., Br. 10, 17). From this posture, the Government claims that plaintiffs were "really" guarantors.

The premise is faulty. Plaintiffs had no right of subrogation against the corporation, express or implied, worthless or valuable. No right of subrogation was reserved in the agreement. Even if an equitable right of subrogation is implied, it would be inappropriately applied here where taxpayers failed to discharge an entire debt. The prohibition against splitting a cause of action is of ancient cognizance; Stark v. Starr, 94 U.S. 477 (1876); Van Norden v. Charles R. McCormick Lumber Co. of Delaware, 27 F.2d 881 (9th Cir. 1928); Henderson v. Morey, 241 Or. 164, 405 P.2d 359 (1965); Wood v. Baker, 217 Or 279, 341 P.2d 134 (1959); plaintiffs' transfer of their fortune and future inheritance fell far short of liquidating the multi-thousand dollar loss. Moreover, taxpayers entered into an agreement of compromise and release with General, obviously destroying any "implied equitable rights of subrogation." Finally, taxpayers transferred all of their personal fortune, including all the stock of the corporation to General; the

Government's waiver theory would necessary posit control of the corporation by taxpayers. Here, the taxpayers were never in the position to control the funds of the corporation.

Assuming, arguendo, that plaintiffs were "guarantors" (or that indemnitors are entitled to subrogation rights despite judicial holdings to the contrary) a payment for a release of taxpayers' liability terminates both the liability and any express or implied right of subrogation. Without a right of subrogation, under the facts posited, there is no "bad debt" deduction pursuant to 26 U.S.C. § 166. Rietzke v. Commissioner, supra; Shea v. Commissioner, supra; Camp Manufacturing Co. v. Commissioner of Internal Revenue, 3 T.C. 467 (1944). The agreement of November 30, 1962 (R. 58-67) wholly releases both plaintiffs and the corporation and terminates any right of subrogation.

The Government's reliance on Putnam v. Commissioner, supra, is unavailing. Putnam is factually inapposite and not controlling. It dealt with a guaranty agreement involving no direct obligation of the taxpayer. The district court's ruling, premised upon such apposite decisions as Howell v. Commissioner, supra; J. J. Shea v. Commissioner, supra; and Rietzke v. Commissioner, supra, is correct and should be affirmed. The assertion that Howell v. Commissioner is somehow distinguishable (Br. 29, 35 seq.) is unappealing; the purported distinctions do not vary the effect of the decision.

The Government, relying upon general textual comments, contends that the existence of the right of subrogation may depend upon the nature of the contract of indemnity (Br. 25, et seq). These comments, taken from the context of a general discussion, are interesting but uninformative.

The right of subrogation either exists or not; no right was specifically reserved in 1958. Even assuming the existence of an implied right to subrogation (contrary to the intent of the parties), such a right would not appertain where a release was executed, since that would be one of the rights remised.

Moreover, the parties did not intend to accord subrogation rights to the plaintiffs who, after the transfer of assets, no longer controlled the subrogee. Thus, the Oregon cases (Br. 32, et seq) concerning liberal attitudes toward subrogation are not germane. Taxpayers possessed no right of subrogation. Even assuming such a right, the compromise transferred that right in return for a full release. Finally, since taxpayers did not discharge the entire obligation (as was done in <u>Putnam</u>), the prohibition against splitting a cause of action would thwart the Government's untenable distinction.

The Government asserts (Br. 33, et seq) that the taxpayers' loss is a nonbusiness bad debt because of the manner in which the parties themselves treated the transaction. Unfortunately, these inferences, based on assumptions outside the record, are faulty.

First, for example, the Government claims that an $11,300 salary item (Br. 34) questioned on another occasion by taxpayer Lee Hoffman in some way permits an inference that the payments by taxpayers to General were contributions to capital or payments pursuant to a guaranty. The facts posited (Br. 34) aliunde the record do not permit the inference or assumption drawn. In truth, prior to the payments by taxpayers under their indemnity agreement to General, taxpayer Lee Hoffman made advances to the corporation. A dispute relating to taxpayers' right to offset these amounts against salary is completely irrelevant to the instant case, as the Government well knows.

Second, the Government relies upon the language in the November 30, 1962 release agreement (Br. 34-35) although the Government itself notes that verbiage does not control substance. The parties agreed that the bank acted as a conduit (R. 32). All payments were made by the taxpayers to General, and not to the corporation or the Bank. (R. 31, 32). The pertinent document is the indemnity agreement executed in 1958.

Third, the Government contends that the April and November, 1961 agreements reflect the type of contract held to be a guaranty in Putnam. (Br. 35-36). This argument is mere wishful thinging. These agreements were executed pursuant to the indemnity agreement of 1958. How could a 1961 document determine the nature and content of the controlling contract executed in 1958? The bargain is for indemnity and no more; Putnam should not be tortured beyond its own internal writhings.

D. Losses Incurred by an Indemnitor Pursuant to an Indemnity Agreement, a Primary Obligation, are Ordinary Losses Deductible Under 26 U.S.C. § 165.

The Government's argument herein (Br. 37-42) does not reflect the law; it is the position of the Government *qua* advocate, an administrative attempt to alter the existing legislation. The simple answer to Argument I D is leave the issue to Congress.

The Government contends that the district court decision requires examination of state law to determine whether or not a debt exists, since the state law of subrogation controls. The statute and the case law are federal and if the Congress wishes to make an alteration, that body should do so, not the Internal Revenue Service. Of course, *Putnam* could be read for the broad proposition that bad debt losses do not depend upon the mechanics or particular language used. But the reason for the tortured result in *Putnam* is the legalistic approach taken by the Internal Revenue Service in an attempt to limit ordinary losses and expand the bad debt category. The brief errs when it assumes, without foundation (Br. 39-40), that there was an infusion of funds into the failing corporation. As explained previously (and see Argument II, *infra*), this is *not* the case despite the Government's continual attempt to so label it.

The Government argues that the district court's determination will allow taxpayers, willy-nilly, to alter capi-

tal losses into ordinary losses. This argument, in other forms, has been thoroughly answered elsewhere. Does the Government really believe that the taxpayers forced the agreement of indemnity in 1958 upon General in order to secure a tax break? And did the taxpayers truly expend their entire fortune, including a share of their future inheritance, in order to thwart the revenue laws of the United States?

The first beginning paragraph on page 40 (Br. 40) is unfounded in fact; it is the basic position advocated by the Government. It is not the law and will not be the law until Congress makes the change. It mistakenly assumes that capital contribution was made, in contradiction to all of the agreed and admitted facts.

The argument regarding Congressional intent and legislative history is interesting minutae. The legislative history is ambiguous. Apparently the Government argues that a subsequently-enacted section somehow specified the prior Congressional intent. The cited section has no legal relevance to the cause. If we are interested in history, is not judicial history more salient? Taxpayers respectfully refer to Howell v. Commissioner, supra; J. J. Shea v. Commissioner, supra; and Rietzke v. Commissioner, supra. These decisions, among others, are much more appropriate for this Court's consideration.

II.

Taxpayers Suffered an Ordinary Loss Deductible Under 26 U.S.C. § 165, Not a Capital Loss.

By alternative argument, the Government asserts that the loss suffered by taxpayers should receive capital loss treatment since the sums were allegedly "contributions to capital." (Br. 43-48).

The Government claims that the admitted facts show the corporation was "in dire financial condition and lacked the essential working capital to continue operation." (Br. 43). This conclusion may not be strictly inferable from the admitted facts, but it may be assumed for sake of argument. The Government proceeds from this premise, however, to the faulty conclusion that taxpayers secured for their corporation "contributions of capital" by the infusion of funds from the bank and General and "when the corporation could not repay these sums" the taxpayers suffered a loss (see Br. 43-48 Passim). This characterization misconstrues the admitted facts.

The Government's inability to envision the loan agreements (R. 38-57) as transactions motivated by a quest for profit (Br. 44) is directly related to its studied dismissal of the indemnity agreement (R. 34-37). The loan agreements were not the original agreements of indemnity--they were executed pursuant to the obligations which flowed from the pre-existing indemnity agreement.

If the Government's contention harmonized with reality, taxpayers would have been making capital contributions to a corporation owned and controlled entirely by General, since the stock in the corporation was among the assets they transferred to General. Common sense reveals the absurdity of this contention.

Had plaintiffs been at liberty to chart their own destiny, it is unlikely that they, as rational persons, would have compelled the corporation to complete the outstanding construction contracts at a loss exceeding one-half million dollars. Yet, this is the very course of action chosen, in the Government's view. It was not to the taxpayers' benefit in 1961 and 1962 to make _any_ contribution of capital to their insolvent entity. None of the monies transferred by the plaintiffs to General benefited the corporation. General had bonded the corporation; pursuant to rights under the indemnity agreement, General determined whether or not the contract would be completed at a loss.

A deductible loss, under 26 U.S.C. § 165, requires a finding that the taxpayers' motive in entering the transaction was primarily one of the profit-seeker. The Government recognizes this position (Br. 43-44), but fails to realize that no other motive is deducible from the admitted facts. _United States v. Keeler_, 308 F.2d 424, 433 (9th Cir. 1962) specifically provides that only the taxpayer's motive or intent is a criteria for determining whether or not a transaction

was one entered into for profit. The admitted facts evoke the conclusion that plaintiffs' motive in executing an agreement of indemnity was solely to enable the corporation to succeed to the plaintiffs' construction business previously operated as a sole proprietorship. Taxpayers intended to enable the business, as continued in a new form, to remain a profitable venture in which taxpayer Lee Hoffman was the sole shareholder, one which paid his salary.

The payments to General in 1961 and 1962 could not be termed an "investment" by any stretch of the imagination. To assert taxpayers were seeking some "loophole" ignores reality and fails to accord with the admitted facts. What taxpayers attempted to do was deduct, for tax purposes, a small portion (an amount equal to their basis) of their entire fortune (including a portion of their future inheritance), which they risked and lost in a transaction entered into for profit. No other motivation is suggested by the Government and none exists.

The Government upon brief has relied upon Keeler, supra, to considerable extent; therefore, the following distinctions are salient:

First, the taxpayer in Keeler executed a contract of guaranty, not an agreement of indemnity.

Second, the Keeler guaranty was given expressly to encourage outside investors to purchase stock in a corporation in which the taxpayer had a substantial interest. Thus, the

guaranty was a direct substitute for investment of capital by the taxpayer. Here, however, plaintiffs' corporation was adequately capitalized and the contract of indemnity was required by the bonding company before it would lend its name as a surety on bonds on public improvements contracts. Keeler is distinguishable from the instant case by reason of the type of third-party obligations secured by the plaintiff's agreement. There was no "investment" secured, directly or indirectly, by entering the indemnity agreement. There was no infusion of equity capital in any form into the corporation.

Third, in Keeler, the loss to which the taxpayer was subrogated was a loss in the value of the capital stock of the corporation; this Court indicated that the taxpayer had no higher rights than those who held the worthless stock. In the case at bench, taxpayers (upon incorporation of their business) agreed to indemnify General for loss in order that their contracting business might continue (as in the past) to bid and perform for public bodies which required payment and performance bonds issued by corporate sureties.

In final analysis, it is unreasonable to assert that plaintiffs gained contributions of capital for their failing enterprise. To have done so would have been the height of folly. Had taxpayers controlled the type of agreement entered, they never would have chosen an indemnity agreement. Instead, taxpayers had no choice of type of agreement; they were bound

to accept the contract tendered by General as a part of its bargain to provide payment and performance bonds. The contract tendered was one long used by compensated sureties. It is inappropriate to confuse the indemnity agreement (R. 34-37) with the agreements entered into years later _pursuant_ to the indemnity agreement (R. 38-57).

III.

The District Court Correctly Denied the Government's Untimely Motion to Amend and Reduce the Judgment.

Judgment was entered on March 21, 1967 (R. 84) after oral argument, submission of voluminous records (see record _passim_, and briefing by the parties. The Government filed notice of appeal on May 16, 1967 (R. 85), and subsequently moved for an extension of time within which to docket the record (R. 86). Although it does not appear from the documents (R. 87-88), the motion to amend and reduce the judgment was filed and served on July 10, 1967 (R. 147). This is almost four months after the rendition of the judgment. No excuse is available for this administrative lethargy. Footnote 22 (Br. 48-49) ineffectively alibis for the Government. The judgment was entered at least 10 days after the filing of the opinion. The Governeent had been on notice as to the existence, nature, basis and amount of the claim since taxpayers initiated their claims for refund. Let us briefly review the _facts_:

Taxpayers filed claims for refund (R. 12-18, 19-22) premised upon a net operating loss carry-back. The Internal Revenue Service denied the refund claim and disallowed the deduction except to the extent of $1,000, plus capital gains during the appropriate years, on the sole and exclusive basis that the losses were capital losses (R. 3, 24). Thereafter, taxpayers filed their complaint for refund of taxes (R. 1-22), incorporating the same theory as presented to the Internal Revenue Service. The Government admitted the filing of the return, amended return and refund claims (R. 23), and further admitted that the claims were rejected (except for a portion of the 1961 claim in the sum of $243.99) and that the Internal Revenue Service's <u>sole</u> basis for denial of the claims was that the losses were capital losses (R. 23).

Thereafter, taxpayers moved for summary judgment (R. 25) and a cross-motion for summary judgment was filed by the Government (R. 69). The case was submitted as one on the merits, or stipulated facts. At no time, to this point, was any contention made or raised by the Government that the sum of $9,345.61 was not the proper sum if the losses were deductible. Indeed, this ambush never occurred until July 10, 1967 (R. 87-88).

Moreover, the Government concurred in and accepted the carry-back theory and judicially admitted the validity of the same. For example, in the Government's brief in opposition to the motion for summary judgment and in support of its

own motion for summary judgment (May, 1966), it stated:

> "This is a suit for the recovery of income taxes in the amount of $9,345.61 plus interest paid by the taxpayer for the years 1958 through 1961, inclusive. (The term taxpayer as used herein shall refer to both plaintiffs, Lee and Judy Hoffman).
>
> QUESTION PRESENTED
>
> "Whether payments made by the taxpayer to a bonding company in the year 1962 are deductible as losses from a transaction entered into for profit under Section 165(c)(2), Internal Revenue Code of 1954, or whether such payments constitute either (1) nonbusiness bad debts deductible under Section 166(d)(2), of the Code, or (2) losses from the sale or exchange of capital assets under Section 165(f) of the Code." (R. 100).

In other words, the Government never questioned the accuracy of the amount sought.

Moreover, in the same document (R. 102), the Government stated:

> "STATEMENT
>
> "The Government accepts as true the facts set out in the taxpayers' affidavit in support of his motion."

The district court properly refused to allow the Government's motion to amend the judgment.[8] The motion

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[8] In addition, the Government stipulated to the facts in open Court:

> "THE COURT: I think you would be better off if you would stipulate to all the facts upon which you are basing your motion for summary judgment.
>
> MR. SMITH: I stipulated to them in my brief. I will now stipulate in open Court." (Tr. 37)

The transcript is not a part of the Record.

was not timely filed and served. Plaintiffs were relieved of submitting additional evidence upon the issue of "trade or business" by the judicial admissions of the defendant. The defendant is barred and estopped by the action of its agents to raise the issue of "trade or business" at this late date. Moreover, the district court, and this Court, can determine from the admitted facts that the taxpayer was engaged in the trade or business of rendering managerial and other services to Lee Hoffman, Inc., the corporation, and that the furnishing of the indemnity agreement was done in connection with such a trade or business.

Following submission of the case, briefing, and oral argument, the Court rendered its opinion and order. The judgment was signed on March 21, 1967 (R. 84). The motion to amend was filed and served on July 10, 1967 (R. 147). The filing of the motion was not timely. See, Rules 6(b), 59(e) Fed. R. Civ. P., 28 U.S.C.; Steward v. Atlantic Refining Company, 235 F.2d 570 (3rd Cir. 1956); Gray v. Dukedom Bank, 216 F. 2d 108 (6th Cir. 1954).

Taxpayers were relieved of submitting any evidence on the issue of "trade or business" by virtue of the judicial admissions of the defendant.

Taxpayers moved for summary judgment, attaching by affidavit extensive statements of fact and pertinent exhibits. The Government then submitted a cross-motion for summary judgment and a brief, admitting the facts asserted by the

taxpayers. In its motion, the Government asserted that "there is no genuine issue as to any material fact." (R. 69). In its brief in support of the cross-motion for summary judgment, the Government accepted the proposition that the suit was one for recovery of taxes paid in the amount of $9,345.61, plus interest, and that the sole question was stated to be whether this was a transaction entered into for profit under 26 U.S.C. § 165, or whether it was a nonbusiness bad debt or capital loss.

By the Government's statements to the Court in its cross-motion for summary judgment, and by its comments in its brief in support thereof, the Government has admitted that there exists no issue of law or fact in connection with the concept of "trade or business" raised in the motion to amend. It is to the public good that there be an end to litigation, and a matter once admitted or decided should remain at rest. Each party is entitled to but a single day in court, and successive or untimely reiteration of decided issues is not in the public interest.

The effect of the Government's admission is to relieve the plaintiffs from the need of offering any evidence on the "trade or business" issue. There was no reason to offer such evidence which, of course, was readily available. To have offered the evidence would have been an interjection of collateral and irrelevant matters into the trial, unduly delaying the judicial process. <u>Morey, Admx. v. Redifer et al.</u>,

204 Or. 194, 264 P.2d 418, 282 P.2d 1062 (1955). Giannone v. United States Steel Corporation, 238 F.2d 544 (3rd Cir. 1956). See also Meltzer v. Atlantic Research Corporation, 330 F.2d 946 (4th Cir. 1964), and Commissioner of Internal Revenue v. Erie Forge Co., 167 F. 2d 71 (3rd Cir. 1948).

The Government judicially admitted that whether or not the plaintiffs were engaged in a "trade or business" was neither an issue of fact nor one of law in this case. It is now too late to raise the issue; it was too late to raise it in July, 111 days after entry of judgment.

The Government is barred and estopped from taking a contrary position. A suit may not be premised upon omissions induced by the one who sues, Stockstrom v. Commissioner of Internal Revenue, 190 F.2d 283, 288, (D.C. Cir. 1951), and this principle, as well as the doctrines of waiver and estoppel, may be applied to the Commissioner of Internal Revenue. Ibid. The District of Columbia Circuit said, 190 F.2d at 289:

> "It has been well said, that the Government should always be a gentleman. Taxpayers expect, and are entitled to receive, ordinary fair play from tax officials."[9]

Estoppel, waiver and unfair inducement principles have often been applied against the Commissioner of Internal

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[9] Disapproved only to the extent that the case holds the Commissioner cannot correct a mistake of law, Automobile Club of Michigan v. Commissioner of Internal Revenue, 353 U.S. 180, 183-184 (1957).

Revenue. See Schuster v. C.I.R., 312 F.2d 311, 317-318 (9th Cir. 1962), where an estate tax return was audited and tax deficiencies paid; a particular trust was not determined includable in the estate. The Commissioner later decided the trust was includable and attempted to assess the bank, which had already distributed the trust assets. See also Exchange and Savings Bank of Berlin v. United States, 226 F. Supp. 56 (D. Md. 1964), estopping the Internal Revenue Service even though the reliance was careless. Confirm, Interstate Fire Insurance Co. v. United States, 215 F. Supp. 586, 599-600 (E.D. Tenn. 1963) [affirmed, per curiam, 339 F.2d 603 (6th Cir. 1964)]; Smale & Robinson, Inc., v. United States, 123 F. Supp. 457 (S.D. Cal. 1954); Walsonavich v. United States, 335 F.2d 96, 101 (3rd Cir. 1964). There is no compelling reason preventing application of the principles of waiver, estoppel, and unfair inducement.

Moreover, the District Court could find from the admitted facts and record that the taxpayer was engaged in the trade or business of rendering managerial and other services to the corporation, and that the furnishing of the indemnity agreement was done in connection with such a trade or business.

Because no issue was ever raised by the Government during either the administrative or the litigation stage, taxpayers' right to carry-back losses under the indemnity agreement with General was assumed by the parties and the

Court was not called upon to decide the issue. However, the Court in deciding the agreed issue, i.e., whether the payments by taxpayers resulted in a bad debt loss or a loss arising from a transaction entered into for profit, held that the transaction was one entered into for profit; in so doing, the Court relied upon the agreed fact that the taxpayer was the salaried president of the corporation and anticipated payments for services if the corporation could successfully conduct its business. The admitted facts indicate that in order to qualify to perform construction work for all public agencies and many private agencies, it was always necessary for the corporation to furnish payment and performance bonds (R. 30). Without taxpayers' agreement to indemnify, General would not furnish the necessary bonds.

Regardless of the definitions of the terms "trade or business" under the Code, it is settled, not only by regulation but also by judicial decision that for the purposes of 26 U.S.C. § 172 (net operating losses), that an employee is engaged in a trade or business and his salary or wage is derived from the operation of that business. 5 Mertons, Law of Federal Income Taxation, § 29.06 p. 71; Swisher v. Commissioner of Internal Revenue, 33 T.C. 506 (1959); Regulations, § 1.172-3(a)(3).

The decisions have been explicit in carrying out the foregoing definition of "trade or business" under 26 U.S.C. § 172 and its predecessor. Folker v. Johnson, 230 F.2d 906

(2nd Cir. 1956); Pierce v. U.S., 254 F.2d 885 (9th Cir. 1958), and cases cited therein. In Folker, supra, the Second Circuit cited with approval the following language of the District Court, 230 F.2d at 909 (n. 5):

> "*** It is true that the business of the corporation was not 'his business'; the separate corporate entity precluded this view even though the taxpayer owned all the issued capital stock, but quite independent of the corporate business, the taxpayer was engaged in trade or business--that of directing and managing the affairs of the corporation. The business of being a corporate officer exists separate and independent of the corporate trade or business. The taxpayer and the corporation, each in law a separate person, each in fact may be engaged in a separate trade or business within the provisions of the tax law. ***."

The Second Circuit concluded, 230 F.2d at 909:

> "Consequently, we hold that the plaintiff, who devoted his entire working time to his duties as a corporate officer, and who received compensation in the form of a salary, was engaged in a trade or business--the trade or business of rendering services for pay. ***."

See also, Harding v. U.S., 113 F. Supp. 461 (Ct. Cl. 1953); Trent v. C.I.R., 291 F.2d 669 (2nd Cir. 1961), and cases cited therein.

The admitted facts show that the corporation was no more than a continuation of the contracting business taxpayer had successfully operated as a sole proprietorship prior to 1958. The "trade or business" of taxpayer changed only to the extent that, during 1958 and prior thereto, he rendered personal services and management to an individual proprietor-

ship and, thereafter, he rendered the same services to the corporation. The corporation would not have been in existence were it not for the taxpayers. By the execution of the indemnity agreement, they made it possible for the corporation to continue in existence.

The most recent case defining "trade or business" is Lundgren v. Commissioner, 376 F.2d 623 (9th Cir. 1967). This Court held that a taxpayer was "in the trade or business of rendering managerial or other services" to his corporation and that the funds advanced to his corporation by the taxpayer therefore bore a proximate relationship to the trade or business which satisfied the requirement of the statute, 376 F.2d at 628. Interestingly, in the Lundgren case, taxpayer as the principal officer of the corporation actually received no salary because he was prevented from doing so by the terms of a Small Business Administration Loan. Lundgren analyzes Whipple v. Commissioner, 373 U.S. 193 (1963) (cited by the Government for a contrary position) and lays to rest such a position.

Thus, had the issue concerning taxpayers' right to carry back the loss been raised timely by the Government, the admitted facts would have justified a finding that taxpayer was engaged in a trade or business--rendering services and managing his corporation--and that the execution of the original indemnity agreement to General was in connection with this trade or business.

CONCLUSION

The judgment of the District Court should be affirmed in all particulars.

Respectfully submitted,

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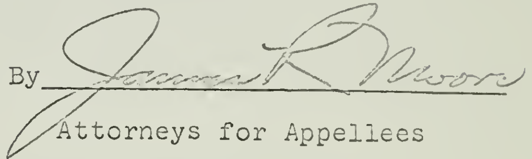
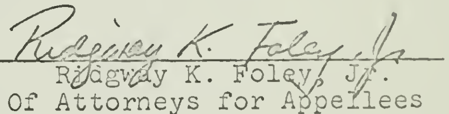
By 

Attorneys for Appellees

CERTIFICATE OF COUNSEL

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing Appellees' brief is in full compliance with those rules.



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APPENDIX A

26 U.S.C. § 165

§ 165. Losses

(a) General rule.--There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of deduction.--For purposes of subsection (a), the basis for determing the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Limitation on losses of individuals.--In the case of an individual, the deduction under subsection (a) shall be limited to--

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into forprofit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100. For purposes of the $100 limitation of the preceding sentence, a husband and wife making a joint return under section 6013 for the taxable year in which the loss is allowed as a deduction shall be treated as one individual. No loss described in this paragraph shall be allowed if, at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return.

(d) Wagering losses.--Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

(e) Theft losses.--For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

(f) Capital losses.--Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) Worthless securities.--

(1) General rule.--If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) Security defined.--For purposes of this subsection, the term "security" means--

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

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26 U.S.C. § 166

§ 166. Bad debts

(a) General rule.--

(1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.--When satisfied that a debt is recoverable only

in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of deduction.--For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Reserve for bad debts.--In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

(d) Non business debts.--

(1) General rule.--In the case of a taxpayer other than a corporation--

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(e) Worthless securities.--This section shall not apply to a debt which is evidenced by a security as defined in section 165(g) (2) (C).

(f) Guarantor of certain noncorporate obligations.--A payment by the taxpayer (other than a corporation)

in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a non-corporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) shall not apply), but only if the obligation of the borrower to the person to whom such payment was made was worthless (without regard to such guaranty, endorsement, or indemnity) at the time of such payment.

* * * * *

26 U.S.C. § 172

§ 172. Net operating loss deduction

(a) Deduction allowed.--There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

* * * * *

(c) Net operating loss defined.--For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) Modifications.--The modificiations referred to in this section are as follows:

(1) Net operating loss deduction.--No net operating loss deduction shall be allowed.

(2) Capital gains and losses of taxpayers other than corporations.--In the case of a taxpayer other than a corporation--

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets; and

(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed.

(3) Deduction for personal exemptions.--No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) Nonbusiness deductions of taxpayers other than corporations.--In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence--

(A) any gain or loss from the sale or other disposition of--

(i) property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) real property used in the trade or business, shall be treated as attributable to the tradd or business;

(B) the modifications specified in paragraphs (1), (2)(B), and (3) shall be taken into account;

(C) any deduction allowable under section 165(c) (3) (relating to casualty losses) shall not be taken into account; and

(D) any deduction allowed under section 404 or section 405(c) to the extent attri-

butable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c) (1) shall not be treated as attributable to the trade or business of such individual.

(5) Special deductions for corporations.--No deduction shall be allowed under section 242 (relating to partially tax-exempt interest) or under section 922 (relating to Western Hemisphere trade corporations).

(6) Computation of deduction for dividends received, etc.--The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) (relating to limitation on aggregate amount of deductions); and the deduction allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities) shall be computed without regard to subsection (a) (1) (B) of such section.

* * * * *

U.S. Code Cong. and Admin. News, Federal Tax Regulations, 1961, § 1.172-3 (a) (3):

(3) Nonbusiness deductions--(i) Ordinary deductions. Ordinary nonbusiness deductions shall be taken into account without regard to the amount of business deductions and shall be allowed in full to the extent, but not in excess, of that amount which is the sum of the ordinary nonbusiness gross income and the excess of nonbusiness capital gains over nonbusiness capital losses. See paragraph (c) of this section. For purposes of section 172, nonbusiness deductions and income are those deductions and that income which are not attributable to, or derived from, a taxpayer's trade or business. Wages and salary constitute income attributable to the taxpayer's trade or business for such purposes.

(ii) Sale of business property. Any gain or loss on the sale or other disposition of property

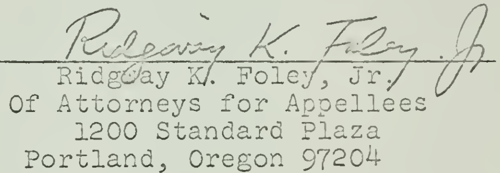
which is used in the taxpayer's trade or business and which is of a character that is subject to the allowance for depreciation provided in section 167, or of real property used in the taxpayer's trade or business, shall be considered, for purposes of section 172(d) (4), as attributable to, or derived from, the taxpayer's trade or business. Such gains and losses are to be taken into account fully in computing a net operating loss without regard to the limitation on nonbusiness deductions. Thus, a farmer who sells at a loss land used in the business of farming may, in computing a net operating loss, include in full the deduction otherwise allowable with respect to such loss, without regard to the amount of his nonbusiness income and without regard to whether he is engaged in the trade or business of selling farms. Similarly, an individual who sells at a loss machinery which is used in his trade or business and which is of a character that is subject to the allowance for depreciation may, in computing the net operating loss, include in full the deduction otherwise allowable with respect to such loss.

(iii) Casualty losses. Any deduction allowable under section 165(c) (3) for losses of property not connected with a trade or business shall not be considered, for purposes of section 172(d) (4), to be a nonbusiness deduction but shall be treated as a deduction attributable to the taxpayer's trade or business.

(iv) Limitation. The provisions of this subparagraph shall not be construed to permit the deduction of items disallowed by subparagraph (1) of this paragraph.

CERTIFICATION OF SERVICE

I, RIDGWAY K. FOLEY, JR., attorney for Appellees, hereby certify that I served by mail three true and correct copies of the Appellees' Brief on counsel for the Commissioner of Internal Revenue on the 22 day of January, 1968. I further certify that the copies were placed in a sealed envelope addressed to Mitchell Rogovin, Assistant Attorney General, Department of Justice, Washington, D.C. 20530; said sealed envelope was then deposited in the United States Post Office at Portland, Oregon on the day last mentioned with the postage thereon fully paid.



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